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FOR U/S JEFFREY FROM AMBASSADOR DERSE

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TAGS: [PREL](#) [ECON](#) [ENRG](#) [PGOV](#) [PBTS](#) [AJ](#)
SUBJECT: SCENESETTER FOR U/S JEFFERY'S APRIL 22-23 VISIT TO
BAKU

Classified By: Ambassador Anne E. Derse per 1.4 (b,d).

¶1. (C) Summary: Energy continues to figure prominently in Azerbaijan's geostrategic vision, economic development, and partnership with the United States. President Aliyev and his senior advisors have repeatedly expressed their commitment to working with the U.S. on a new phase of energy cooperation, centered on the export of Caspian gas reserves, in which Azerbaijan can play an important role as both a producer and a transit country. The immediate question is whether Azerbaijan and Turkey can reach agreement on gas transit and, further on, whether Azerbaijan acts to develop its energy resources in an optimal and expeditious manner. Azerbaijan's rapidly growing energy revenues - estimated at USD 200 billion over the next 20 years - threaten to further distort an already heavily energy-dependent economy. Although Azerbaijan's overall macroeconomic situation is relatively stable, endemic rule-of-law and corruption problems, as well as monopolistic practices severely hinder growth in the non-energy sectors. End summary.

FIRST ENERGY PHASE: BTC AND SCP

¶2. (C) The July 2006 inauguration of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline (from the offshore ACG oil mega-field) and the December 2006 start-up of the South Caucasus (SCP) Pipeline (from the offshore Shah Deniz gas mega-field) marked the successful completion of Azerbaijan's first phase of post-independence energy development. Income from these two projects is now fueling Azerbaijan's 25 percent GDP growth. Azerbaijan is starting the second phase of its development, which will focus on gas exports to Europe and the development of new transit routes for Eastern Caspian energy exports. Azerbaijan is grateful to the United States for its strong role in promoting Azerbaijan's first phase of energy development, and is looking to the U.S. for continued leadership and strong partnership in the second phase.

GAS TO EUROPE

¶3. (C) Shah Deniz Phase One gas flows started in late 2006, with most of the 8.6 billion cubic meters annually going to Turkey. The second phase of development for the Shah Deniz (SD2) field promises to yield approximately 13 bcm/a of gas at a date no earlier than late 2013. President Aliyev has stated his desire that all SD2 gas be exported to Europe, with his motivation being to increase Azerbaijan's alliances with European countries. However, Turkey has been insisting upon a transit system whereby an amount equal to 15 percent of transiting Azerbaijani gas is sold to Turkey at a preferential price. Azerbaijan has staunchly resisted

linking transit and gas sales to Turkey, saying that Turkey must have a fair and transparent transit regime so that Azerbaijani and eventually Turkmen and/or Kazakh gas is encouraged westwards. Azerbaijan has told Turkey it is willing to sell some SD2 volumes to it at a good price, but that this sales cannot be linked to other contracts Azerbaijan makes with consumers downstream. Turkey and Azerbaijan have been extremely reluctant to discuss this matter bilaterally at a political level, each seeking surrogates to put pressure on the other. There are recent indications that Turkey and Azerbaijan could come to an agreement on a gas transmit regime.

¶4. (C) There are three main competing pipeline projects for SD2 gas: Turkey-Greece-Italy (TGI), Trans-Adriatic Pipeline (TAP) and Nabucco. The State Oil Company of Azerbaijan (SOCAR) has been pursuing gas sales and purchase negotiations with companies involved with each of these projects. However, Shah Deniz Consortium members are worried since Azerbaijan is unwilling to conclude any sales and purchase agreement with European gas consumer companies for SD2 volumes until and unless transit through Turkey is first worked out.

¶5. (C) Shah Deniz Consortium members say that SD2 volumes will be approximately 13 bcm/a, two of which are expected to go to Georgia and Azerbaijan, leaving 11 bcm/a at the Turkish-Georgian border. Turkey is expected to buy at least 2 to 5 bcm (and possibly more), leaving 6 to 9 bcm for sale to Europe. This amount is not enough to fill TGI and also start Nabucco, hence Azerbaijan will have to make hard decisions as to which pipeline project to support. Recent signs indicate that Azerbaijan, as a reward to Turkey for voting with it on the Nagorno Karabakh UNGA resolution, could sell more than this amount to Turkey, increasing the

possibility that there would be too little Shah Deniz Phase II gas after sales to Turkey to sanction any of the pipelines vying for this gas.

¶6. (C) Azerbaijan has ample gas resources, with industry and government analysts saying that it could export at least 20 bcm/a to Europe o/a 2020, but an essential prerequisite is expeditiously developing its other offshore fields, with the first focus being the "deep gas" found under the current Azeri-Chirag-Guneshli (ACG) field. However, ACG Deep Gas, for which the ACG Consortium led by BP has right of first refusal, has been held up by disagreements between the GOAJ and BP. Recent resolution of the most important of these disagreements could open the way for development of the ACG Deep Gas. However, given the long lead times involved in developing gas fields, particularly in the Caspian where there is a real shortage and competition for capital assets, Azerbaijan must be exhorted to move quickly to develop ACG Deep Gas and other promising fields in conjunction with international oil companies, so that this gas will be available to the European market in the near-term (i.e., by o/a 2020). We should continue to encourage the GOAJ to expeditiously develop its gas resources in conjunction with (preferably American) IOCs.

TRANS-CASPIAN ISSUES

¶7. (C) The December 2006 death of then-Turkmen President Niyazov sparked a growing rapprochement between Azerbaijan and Turkmenistan, which could lay the groundwork for new Trans-Caspian energy cooperation. The two countries resolved a long-standing debt issue and Turkmenistan reopened its Baku Embassy this month. More importantly, the two countries seem to agree in principle that joint development of offshore energy need not wait resolution of delimitation issues. Flows of Turkmen offshore gas, such as gas from its Block One field, can flow west without a full-scale pipeline by making use of existing underwater pipe systems used for Azerbaijan's SD and ACG fields, although significant modifications of this system would have to occur in order to accommodate Turkmen volumes. Were the GOTX to decide to ship some of its gas

westwards through Azerbaijan to Europe, it could be another significant source of Caspian gas for Europe, in addition to helping to lessen the GOTX reliance on Russia. President Aliyev told us on April 16 in confidence that planning is now underway for Turkmen President Berdimuhamedov to visit Baku, possibly next month. Azerbaijan is to be commended for its outreach to the Turkmen, and we should continue to offer help as needed.

¶18. (C) Azerbaijan stands poised to serve as a significant transit country for Kazakh oil volumes, both from Tengiz and from Kashagan. However, rent-seeking activities from oligarchs in both Azerbaijan and Kazakhstan threaten to weaken the commercial attractiveness of this Southern Corridor. Azerbaijan should be encouraged to optimize the commercial attractiveness of this corridor so that Kazakh volumes are not exported via Russia or Iran.

GEORGIA -----

¶19. (C) Georgia is the weakest link in the Southern Corridor, as it has no indigenous hydrocarbons and is dependent on Russia for gas, especially in the winter. Azerbaijan has traditionally sold Georgia gas during the winter at sub-market prices, but is unwilling to continue to do so without compensation in some form. Georgia has sought to link future sub-market price gas from the GOAJ with issues such as allowing the opening of the SOCAR-owned Kulavi oil terminal in Georgia or not charging exorbitant tariffs on GOAJ petroleum products moving to Georgian terminals by rail. Despite the difficulties, President Aliyev said on April 16 that he had instructed SOCAR to sign a deal at USD 200/tcm with Georgia for its gas needs this year. Azerbaijan should be encouraged to continue to negotiate in good faith with Georgia over future gas sales.

MACROECONOMIC OVERVIEW -----

¶10. (SBU) Azerbaijan's economic performance in 2007 showed increasing resilience and strength as GDP grew by more than 25 percent, a slight moderation from GDP growth in excess of 30 percent in 2006 and 2005. Azerbaijan's growth prospects remain closely linked to oil prices, given that the energy sector provides 95 percent of total export earnings and more than 50 percent of GDP and 60 percent of budget revenue. In 2007, inflation reached 19 percent and in 2008 inflation looks likely to exceed 20 percent. In the coming year, the economy will continue to grow as Azerbaijan will receive a larger share of profits from the ACG production sharing agreement. In 2007, the Azerbaijani manat appreciated in nominal terms against the U.S. dollar by less than 3.5 percent.

¶11. (SBU) The Government of Azerbaijan's 2008 consolidated state budget exceeded USD 20 billion and the government will likely increase budget expenditures in June in the supplemental budget package. Major structural impediments continue to hinder growth in non-oil sectors. According to official statistics, the non-energy sector led by construction and services, grew by nearly 12 percent in 2007 with the agricultural sector rebounding slightly. The agricultural sector still lacks much of the basic infrastructure required to be a real engine of rural development and growth. The lack of infrastructure development (water, electricity, roads, and other basic infrastructure) has hindered the sector's growth prospects. Key macroeconomic issues such as exchange rate adjustment and related price pressures, expansionary fiscal policy and the slow growth in the non-energy tradeables sector remain the major challenges for the GOAJ.

STATE OIL FUND -----

¶12. (SBU) Since its creation in 1999, the State Oil Fund of

Azerbaijan (SOFAZ) has acted as Azerbaijan's energy revenue sterilizer and long-term savings vehicle. The bulk of SOFAZ's inflows come from proceeds generated under production sharing agreements from sales of Azerbaijan's share of hydrocarbons; bonuses paid under the terms of production sharing agreements; acreage fees and other revenues. SOFAZ is one of the most transparent GOAJ organizations publishing internationally audited quarterly and annual reports. SOFAZ also plays a leading role in the Extractive Industries Transparency Initiative (EITI). In 2007, the United Nations awarded SOFAZ a public service award for its transparency, accountability and responsiveness in the public sector.

¶13. (SBU) SOFAZ's currently has assets in excess of USD 2.5 billion (expected to grow to USD 6 billion this year, and USD 10 billion by 2010, based on an oil price of USD 55). SOFAZ's portfolio was invested in 55 percent U.S. denominated assets (dollars and U.S. treasuries), 35 percent in Euros, five percent in British Sterling pounds and a small amount in other currencies, corporate bonds and other fixed income instruments. In 2008, SOFAZ plans to reallocate its portfolio to 50 percent dollar denominated assets and 40 percent Euro assets. In 2007, its rate of return was approximately five percent in real terms. Using a grant from the U.S. Trade and Development Agency, SOFAZ is now re-evaluating its portfolio strategy and developing a more aggressive investment strategy with the goal of boosting SOFAZ assets' rate of return. The management of SOFAZ assets appears sound. However, not all oil and gas revenues are managed by SOFAZ. The note that they control only 75 percent of income above USD 50/barrel. The remainder is controlled by SOCAR and other elements of the government.

REFORM

¶14. (C) Securing and advancing U.S. interests in the longer term depends on Azerbaijan's continued stability and development. Although President Aliyev and his closest advisors continue to affirm their commitment to democratic reform, Azerbaijan's progress has been disappointing. The media environment is heavily restrictive, with transparently implausible criminal court cases against journalists and violent attacks against journalists that have gone unprosecuted and unpunished. Freedom of assembly in practice is severely limited. Opposition parties complain that the GOAJ has placed undue restrictions on their ability to organize and do basic grassroots work, and believe that they must have parity in electoral commissions in order to have a level playing field. Only a handful of opposition parties acknowledge that they too have a role to play in creating a positive environment by developing serious party platforms and engaging in a responsible dialogue with the GOAJ. Although the October 2008 presidential election presents a tremendous opportunity for President Aliyev to burnish Azerbaijan's democratic credentials at very little domestic political risk, senior GOAJ officials - including President

Aliyev - have hinted that they see very little incentive for the GOAJ to provide a political opening in the run-up to the election, particularly as they believe that Azerbaijan is unfairly held to a higher standard with respect to democratic reform than neighboring Georgia and Armenia.

¶15. (SBU) On the economic front, WTO accession could help bring about the legislative and regulatory changes needed to reform Azerbaijan's economy and introduce transparent, market-driven practices. President Aliyev pledged to support accelerating Azerbaijan's WTO accession in 2007 and, with the help of USAID's Trade and Investment Program, Azerbaijan has made some progress towards accession. The GOAJ has a Working Party meeting scheduled in Geneva on May 6, and hopes to hold bilateral negotiations on its goods and services offer with several countries including the U.S. on the margins of the Working Party meeting. While the legislative drafts and services offer are ready for discussion, U.S. Trade Representative (USTR) has requested several changes to the format and substance of Azerbaijan's goods offer as a

prerequisite to a bilateral negotiation on goods. To maintain the timeline the GOAJ set for itself on WTO accession (to finish the accession process in less than two years and before Russia), the GOAJ will need to quickly revise its current goods offer in order to hold bilateral negotiations on both its goods and services offer around the May 6 Working Party meeting.

NAGORNO KARABAKH

¶16. (C) The Azerbaijani Government - including President Aliyev - remains unhappy with the OSCE Minsk Group Co-Chairs' "no" vote on Azerbaijan's UNGA resolution regarding Nagorno Karabakh and the occupied territories. The GOAJ feels strongly that the Co-Chairs should have abstained, rather than voted against the resolution, in order to retain their neutrality on issues related to the conflict, and maintains the U.S. position was "unexpected." The GOAJ, which insists that the Nagorno Karabakh conflict should be resolved on the basis of Azerbaijan's territorial integrity, seems to increasingly believe that the Minsk Group is unable or unwilling to impose or facilitate a solution to the conflict that is in keeping with Azerbaijan's fundamental interests. While we do not believe that the GOAJ's current frustration over the Nagorno Karabakh peace process - and our position on the UNGA vote - will affect our energy cooperation, President Aliyev and other senior GOAJ officials are likely to express their disappointment over the UNGA vote, and urge the U.S. to play a more active role in seeking a resolution to the Nagorno Karabakh conflict, which remains Azerbaijan's top domestic and foreign policy priority.
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